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by

Robin Boadway

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Department of Economics
Department of Political Science
Social Science Centre
The University of Western Ontario
London, Ontario, N6A 5C2
Canada

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Should the Canadian Federation be Rebalanced?

Robin Boadway
Queen's University

April, 2004

Abstract

Recent changes in the federal-provincial transfer system have left the Canadian federation in a state of vertical fiscal imbalance. Given the tax room occupied by the federal government and the provinces, the magnitude of transfers is insufficient to sustain the relative levels of expenditure responsibilities into the future. Sooner or later some choice must be made between ceding further tax room to the provinces and increasing transfers. In this paper, we outline the cases for each of these two courses of action, and argue that federal tax room should be jealously guarded and the imbalance addressed by increasing transfers to the provinces. The argument is based both on tax harmonization considerations and on the importance of federal transfers as a means of accomplishing national efficiency and equity objectives.

Keywords: federal-provincial transfers, fiscal imbalance, fiscal gap

JEL Classification: H7

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The Issue

The Canadian federal fiscal system, like those worldwide, is characterized by a fundamental asymmetry between the revenues raised at the federal level and its expenditure responsibilities. The federal government raises more revenues than it requires for its own program spending, and transfers the excess to the provinces. The bulk of the transfers takes two forms: equalization, which goes to those provinces with below-average revenue-raising capacity, and social transfers, which go to all provinces on a more or less equal per capita basis. The provinces then have essentially the same asymmetric financial relationship with their municipalities.

This asymmetry is variously characterized as a vertical fiscal gap or, more pejoratively, as a fiscal imbalance between the federal government and the provinces. It has come to the fore in the past decade because of the abrupt cut in federal transfers to the provinces as part of the debt reduction policies of the 1990s, and the related perceived crisis in the funding and sustainability of provincial health care systems. Many observers regard fiscal imbalance as a fundamental problem requiring attention. These include not only policy economists and public policy think tanks, but also provincial governments. Indeed, a Quebec *Commission on Fiscal Imbalance*, reporting to the previous PQ government and chaired by the current Quebec Finance Minister, Yves Seguin, argued for a radical rebalancing of the federation to eliminate all but a small amount of the fiscal gap. Its recommendations essentially involve replacing the social component of existing transfers with a substantial reallocation of revenue-raising authority from the federal government to the provinces. On the other hand, the Romanow Royal Commission, echoing the views of many provinces, has argued in favor of rebalancing in the opposite direction, such as by increasing social transfers to the provinces to increase the share of federal financing of provincial health care programs. The federal government, for its part seems more intent on programs that transfer funds directly to individuals and institutions without going through the provincial governments. These various options have taken on policy significance, and are likely to be prominent on the agenda of the Martin federal government.

There is also a serious horizontal imbalance that is not unrelated to the vertical one. As a recent agreement among the Provincial and Territorial Finance Ministers documented, the gap in revenue-raising ability between Alberta and Ontario far outweighs that between Ontario and the equalization receiving provinces. This leads to a situation in which natural resource revenues are treated very asymmetrically between the have and have-not provinces. Although much of our concern is with vertical imbalance, our discussion will touch upon horizontal imbalance as well.

Much is at stake for Canada. The resolution of the fiscal imbalance issue is of immense importance to the functioning of Canada's social and economic union. Moreover, any change along the lines of the Seguin Report or its analogues are

likely to be largely irreversible at least for the foreseeable future. Thus, it is important that we get it right.

Unfortunately, the terms of the debate are far from transparent. They involve seemingly arcane concepts like tax-point transfers, the representative tax system (RTS) approach used for equalization, the role of the spending power, tax harmonization, and the federal share of financing health care. Although these are not difficult in principle to understand, the fact that they involve transactions among governments that do not directly impinge upon citizens and their representatives seems to reduce all incentive to understand them and their implications, and makes the public policy process hostage to a subset of vocal policy advocates.

My purpose is to outline what is at stake, weigh the pros and cons of various actions, and in the end take a position that is perhaps rather provocative.

Before beginning, it is useful to state an important caveat. Discussion about the structure of the federation is far from scientific and relies on much more than empirical investigation, despite the fact that there is a rich body of theoretical and empirical research on the topic. For one thing, the main actors are governments—federal, provincial and municipal—and, unlike with individuals and firms, we are a very long way from understanding government behavior. Also, values are inextricably involved. Whether we like it or not, governments in their economic policy guise are largely institutions for redistribution broadly construed. It is necessary to take a stance on the redistributive role of government in order to take a position about how the federation should be structured. Reasonable people can reasonably disagree.

Some Background

Canada's federation is a highly decentralized one, probably the most decentralized in the world. Spending at the provincial-local level is much higher than at the federal level. Exclusive legislative responsibility for major public goods and services are in the hands of the provinces, and these include significant social programs in the areas of health, education and welfare. Indeed, the bulk of provincial spending are for these programs, and they are among the most rapidly growing areas of public spending. At the same time and unique among federations, provinces have virtually unfettered access to revenue sources, and raise a substantial proportion of their own revenues. Indeed, they have access to more revenue sources than the federal government. Nonetheless, they are not fully self-sufficient and rely on federal government transfers for a significant proportion of their revenues.

Over the past several decades, the federation has been gradually becoming more and more decentralized. Provincial program spending has grown rapidly relative to the federal government owing to the nature of provincial responsibilities, and at the same time reliance on federal transfers has gradually declined. Although decentralization has evolved gradually and inexorably, there

have been some periods of sharp and unannounced change, the most notable of these during the federal deficit reduction programs of the mid-1990s. The Martin federal budgets relied disproportionately on cutbacks of cash transfers to the provinces to address their fiscal objectives, thereby undoubtedly passing deficit problems onto the provinces (who in turn did the same to the municipalities).

This evolving process of decentralization punctuated with various episodes of abrupt change illustrates what fiscal federalism specialists take for granted. Even though in principle, both levels of government have unencumbered access to all the major forms of revenue raising, the extent to which the provinces in the end rely on their own revenue relative to transfers from the federal government is endogenously determined and reflects the interdependencies of federal and provincial decision-making. That is, the vertical fiscal gap is what economists call an equilibrium outcome: it is the outcome of decisions taken more or less independently by the two orders of government. However, it is an equilibrium outcome of a process in which the federal government likely has a dominant say, what is referred to as a first-mover advantage. Given the spending responsibilities of the two levels of government, the extent of fiscal gap and fiscal imbalance depends on the amount of tax room the federal government occupies and the amount of transfers it chooses to make. The provinces are bound to take that as given. Thus, to that extent, the vertical fiscal gap and any imbalance in the fiscal relations between the two levels of government is largely under the influence of the federal government.

Another feature of federal-provincial interdependence is worth mentioning. The two levels of government undertake fiscal decision-making in the Canadian federation independently. To use economics jargon, fiscal decision-making and the federal-provincial equilibrium that results from it is more non-cooperative than cooperative in nature. This might be partly a result of our parliamentary system of government whereby fiscal decisions must ultimately be done in parliaments and legislatures. But it might also be due to institutional features of the Canadian federation. Unlike other federations, there is no arms-length federal-provincial advisory body that facilitates cooperative outcomes, like the Commonwealth Grants Commission in Australia, the Financial and Fiscal Commission in South Africa, or similar bodies in other federations.

From this, two relevant observations follow. First, under our existing federal fiscal system, given the preemptory role played by the federal government, the balance of the federation to a large extent relies on federal government initiatives. It is the federal government that must ultimately play the major role in any rebalancing of the federations. Second, the non-cooperative nature of the fiscal-federal equilibrium limits the ability of the federal government to achieve outcomes that might be in the social interest. The search for mechanisms to enhance cooperative decision-making might be worthwhile.

Sorting Out Responsibilities

Sections 91-95 of the *British North America Act* set out the division of the main legislative responsibilities of the two orders of government. To some, matters might end there. If the provinces have exclusive legislative responsibility for, say, health, one might think that they should be allowed to exercise that responsibility: the federal government should butt out. However, matters are not so simple for two main reasons. The first is that the division of responsibilities in no way resolves the vertical fiscal gap issue. It sets out expenditure responsibilities, and it provides the federal and provincial governments with taxing powers. But it does not require that one balance the other, so it does not resolve the determination of vertical fiscal gap. Virtually any fiscal gap is consistent with the constitutional division of legislative responsibilities.

The second, and more important, reason is that the division of powers is largely functional in nature: it is not goal-oriented. No one level of government is, or can be made, responsible for economic efficiency in its various aspects, or redistributive equity, or other social goals that are part and parcel of economic objectives. On the contrary, policy instruments used by both levels of government contribute jointly to economic and social objectives construed more broadly. More important, the Constitution explicitly recognizes the interest and responsibility the federal government has for objectives that are addressed mainly by policy instruments that are the sole legislative responsibility of the provinces. To be more explicit, refer to Section 36 of the *Constitution Act 1982*, which reads:

(1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

(a) promoting equal opportunities for the well-being of Canadians;

(b) furthering economic development to reduce disparity in opportunities; and

(c) providing essential public services of reasonable quality to all Canadians.

(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Section 36(2) forms the basis for the equalization program, a program which is itself coming up for renewal and about which there is substantial controversy. Section 36(1), however, is the main source of conflict between provincial legislative jurisdiction and federal responsibilities. The commitments listed are all those that are addressed by provincial spending programs, including important social programs in the areas of health, education and welfare. To the extent that

these commitments are taken seriously, they imply some federal influence over provincial spending programs.

More generally, one can argue without reference to the Constitution that there are economic and social objectives that have a national dimension, although there is certainly room for debate as to their breadth and importance. These include on the one hand redistributive equity in its various dimensions: social insurance, equality of opportunity, income equality, poverty elimination, and so on. There are legitimate differences between those who believe that, for example, equality of opportunity should be provincial rather than national in scope. But as a matter of principle, the view that there ought to be some minimum national standards of redistributive equity is a defensible position, and one that is implemented in at least some policy areas (e.g., the tax system, EI, pensions). At the same time, there are objectives of economic efficiency that are particularly national in nature, such as efficiency in the internal economic union (the absence of inter-provincial barriers to the movement of products and factors of production). The national dimension of these principles of redistributive equity and efficiency in the internal economic union have in fact been recognized by the provinces in parallel inter-governmental agreements: the *Social Union Framework Agreement* (SUFA) covering redistributive equity and the *Agreement on Internal Trade* (AIT) covering national efficiency. Thus, the legitimacy of a national role cannot be discounted lightly.

How then can the federal government pursue these objectives, especially given the exclusive legislative responsibility of the provinces? Methods used in other federations, such as mandates and constitutional enforcement, can be readily ruled out. That leaves three sorts of alternatives, all of which have implications for the balance between federal and provincial fiscal positions.

The spending power. The use of federal-provincial transfers with conditions attached is potentially the surest means by which the provinces can be encouraged or induced to take account of national objectives in the design of spending programs. However, the use of the spending power is not without problems, especially when it involves major provincial public services in areas of health, education and welfare. These programs have redistributive goals as their main objective and rationale, and it is much more difficult to formulate and to agree upon these goals, and then to interpret them. The general conditions of the *Canada Health Act* are a good example of this. This vagueness of objectives leads to several potential sources of friction. These include the definition of the conditions, the extent of intrusiveness of the federal government in provincial decision-making, the extent of transfers needed to enforce the spending power when it is first initiated and as it is subsequently maintained, the interpretation of the general conditions, and their enforcement by the federal government. Obviously these problems are made more difficult the less cooperation there is between the provinces and the federal government. They are also made more difficult the smaller the size of the transfers used to engage the spending power in a given provincial program.

Moral suasion. It is conceivable that the federal government can have considerable influence over provincial program design simply by combining federal-provincial transfers with moral suasion. This avoids the need to codify general conditions as well as to interpret them. The effectiveness of this will depend upon both the extent of cooperation between the two levels of government and the size of transfers. It is difficult to know the extent to which moral suasion has been used in the past. However, it is possible that moral suasion has had some implicit effect in both the welfare and post-secondary education areas, and that this effect waned as federal transfers declined. Thus, until recently, provinces treated out-of-province residents on a par with their own residents when it came to determining the terms under which services in these areas could be used.

Federal-provincial agreement. Some of the problems with the spending power as a means by which the federal government exercises its responsibility for achieving national objectives can in principle be overcome by negotiating agreements with the provinces rather than applying spending power conditions unilaterally. However, this too is fraught with difficulties. Agreement is notoriously difficult to achieve, especially where near unanimity is required. A negotiated agreement must spell out the terms of the agreement with more precision than those attached to the spending power. It must include not only the conditions that provincial programs must satisfy, but also federal financial obligations and dispute settlement procedures. These difficulties account for the relative lack of success of federal-provincial negotiation as a means of achieving national objectives, except in fairly narrow policy areas. The two agreements that have been negotiated to address national efficiency objectives (the AIT) and national equity objectives (the SUFA) have had very limited success. The AIT lacks an effective dispute mechanism, while the SUFA is really more an agreement over process. It is not clear that any negotiated agreement can have a dispute settlement mechanism that is as effective as that used in the spending power, that is, federal government enforcement.

The relevance of these alternatives is very much bound up with the nature of rebalancing that the federation might undergo. Before turning to that, it is necessary to clarify the conceptual nature of rebalancing the federation.

VFG versus VFI

We have used the two terms *vertical fiscal gap* (VFG) and *vertical fiscal imbalance* (VFI). A subtle but important distinction between these concepts should be cleared up before proceeding to more prescriptive arguments. Both of these concepts are highly imprecise, but the conceptual distinction between them is nonetheless an important one. The concept of VFG is related to one's view of the optimal division of responsibilities between the federal government and the provinces, and the optimal exercise of those responsibilities. It is useful to take the division of expenditure responsibilities between the federal and provincial governments as given. There is much less disagreement about this than about

the revenue side. Expenditure responsibilities are after all set out in the Constitution. Suppose then that one has a view about the optimal exercise of these responsibilities. This leads one to a view about the optimal size of federal and provincial expenditures and how they are likely to evolve over time.

Given these expenditure requirements, the issue is then how should they be financed. It is here that the concepts of VFG and VFI kick in. Setting aside issues of budget deficits, there will be a total amount of revenue that has to be raised to finance the sum of provincial and federal expenditures. The extent of VFG is equivalent to a view about how revenue-raising should be divided between the two levels of government. There may be various reasons why the federal government should be responsible for raising more revenues than it requires for its own spending purposes, and the provinces correspondingly less. These include arguments about the benefits of tax harmonization, the use of the tax system for national redistributive objectives, the costs of destructive tax competition, and the very different revenue-raising capabilities of the provinces. And, the need for federal-provincial transfers also factors into one's view about the ideal VFG: that is, federal-provincial transfers may be desirable in their own right rather than being a residual determined by the separate determination of expenditure and taxing responsibilities. These arguments will be relevant when we consider the pros and cons of rebalancing later on. For now, we simply note that the VFG refers to the *desired* asymmetry in revenue-raising between the federal and provincial governments. The higher the VFG, the more centralized is revenue-raising, and vice versa. Equivalently, the more centralized is revenue-raising, the larger should be the amount of federal-provincial transfers required to finance the spending at the two levels of government.

The federal fiscal system will be in balance if federal-provincial transfers are sufficient to finance the optimal level of provincial and federal spending given the division of revenue-raising, that is, given the VFG. A VFI will exist if the level of transfers is not consistent with the division of revenue-raising, given expenditure responsibilities. There can either be a positive or a negative VFI, although given the preemptive nature of federal decision-making, concern is typically over the imbalance taking the form of inadequate transfers. In any case, the VFG and the VFI are conceptually distinct. It is possible to have any size VFG without any VFI, and it is useful to keep that in mind in what follows.¹

To repeat, there is nothing precise about these concepts. There will be disagreement about the optimal sizes of provincial and federal expenditures, as well as about the division of revenue-raising responsibilities. Moreover, given the independent discretion over tax policy, the division of revenue-raising cannot really be taken as exogenously given. The existence of federal and provincial public debt makes the concept even more imprecise. Nonetheless, the distinction

¹ Conceptually, one can think of the relationship between the VFG and the VFI as follows: $VFI = VFG - \text{Actual Transfers}$. Of course, in the real world where deficit financing is possible at both levels of government, the concepts of VFG and VFI become blurred. Even if one has a good idea of what the VFG should be in the long run, economic shocks put the federal finance off course making it difficult to be definite about when a VFI exists.

between VFG and VFI is useful as a way of organizing one's thoughts. If one thinks the current fiscal system exhibits VFI but is otherwise satisfied with the VFG, the remedy is to increase transfers to the provinces. On the other hand, one may have a more fundamental problem with VFG and prefer either more or less decentralization of revenue-raising.

Interestingly, the Seguin Commission understood clearly the distinction between VFG and VFI (without using the terminology), and even attempted to estimate empirically the sizes of the two. Their policy recommendation was intended to address both their perception about the existing VFI and their normative views about the VFG. In particular, they argued—convincingly in my view—that there was a serious VFI, brought about in large part by the substantial unilateral reduction in federal transfers to the provinces during the deficit reduction years of the Paul Martin Finance Ministry. Federal reductions in cash transfers to the provinces were much larger in percentage terms than reductions in other federal spending programs, effectively reshuffling the federal deficit problem to the provinces. At the same time, they argued that the underlying VFG—the division of revenue-raising responsibilities—was much too large. This view was not based on some notion of the ideal division of revenue-raising responsibility, but on the role of the VFG as a source of federal-provincial transfers. Their view was that federal-provincial transfers should only be used to fulfil equalization commitments, and not for any other spending power purpose, especially conditional grants in areas of provincial jurisdiction. The Seguin Commission implicitly discounted arguments about the disadvantages of a more decentralized tax system. They argued that the combination of eliminating the CHST transfer and turning over the GST to the provinces would both undo the VFI and correct what they saw as an underlying VFG.

The precise recommendation of the Seguin Commission in fact makes little sense from the point of view of the rest of Canada. The federal GST and the Quebec Sales Tax (QST) are already harmonized, and by a unique arrangement, Quebec collects both the QST and the GST within its borders. Turning over full responsibility for the GST to Quebec would be a relatively simpler matter. It would be much more difficult elsewhere in Canada where either provincial retail sales taxes are not harmonized with the GST (or do not even exist, in the case of Alberta), or where they are harmonized but the federal government administers the tax. But the more important point of the Seguin Commission is their insistence that both a VFI and a VFG exist, and that this can only be addressed by a major reallocation of tax room from the federal government to the provinces along with a reduction in federal transfers. That the tax room reallocation cannot reasonably be achieved by decentralizing the GST is not a telling criticism. The obvious alternative of the federal government turning over income tax points to the provinces is a viable alternative that commentators elsewhere in Canada have proposed.

This leads us to address the key issues raised by the Seguin Commission of whether the Canadian federation is out of balance, and if so how a new balance can be struck.

Rebalancing the Federation

The evidence presented by the Seguin Commission pointing to a VFI in the current fiscal transfer arrangements is reasonably convincing. It was based on projections done by the Conference Board of Canada of future public expenditure requirements relative to revenue growth and the ability of the current structure of transfers to cope with it. These kinds of projections are naturally judgmental and have led to considerable debate and dispute, especially by the federal government. Without going into the details, the existence of a VFI of some magnitude is plausible. Taking that as a given, two interdependent questions arise, and they parallel the questions asked by the Seguin Commission. How should that imbalance be addressed? And, should the VFG be adjusted at the same time?

Taken together, this is equivalent to asking what combination of changes in federal-provincial transfers and tax room reallocation should be undertaken to address the existing imbalance. The answer ultimately depends upon one's view of the appropriate VFG, the issue addressed head-on by the Seguin Commission. To assess this issue, let us consider in turn the arguments in favour of a lower VFG and for maintaining the existing VFG. The former would support addressing the VFI by relying largely on turning federal tax room over to the provinces, while the latter would protect federal tax room and increase federal transfers to the provinces.

Arguments for Reducing the VFG

There are a large number of arguments for reducing the VFG and making the provinces more fiscally self-reliant. A list of some of the more important ones would include the following.

Provincial sovereignty. Foremost in the minds of some provinces—including, but not exclusively, Quebec—is to eliminate the use of the spending power in areas of exclusive provincial legislative jurisdiction. While in principle it is possible to close the fiscal gap with purely unconditional transfers that do not impinge on provincial autonomy, the argument is that the federal government will always be tempted to attach conditions on transfers it makes to the provinces. To avoid that, one simply reduces transfers in the first place. Note that this argument places primacy on the optimal size of federal-provincial transfers rather than on the optimal assignment of revenue-raising responsibilities as the main determinant of the VFG. It implicitly accepts that any disadvantages that might arise from the decentralization of revenue-raising to the provinces, such as adverse tax competition, are dominated by the advantages of avoiding large transfers. Note also that this argument does not entail a zero VFG. Even the strongest proponents of reducing the VFG still regard some minimal VFG necessary for equalization purposes.

Provincial versus national equity. A related argument for reducing the VFG is that equity should be more a provincial than a federal responsibility. Equivalently,

social solidarity is stronger at the provincial than at the national level. According to this, there is no case for the use of the spending power to induce national standards in social programs, nor is there a need for federal dominance in the income tax field in order to achieve national redistribution objectives.

Accountability. It is argued that political accountability is enhanced to the extent that provinces raise their own revenues to finance their spending programs. Accountability to citizens might be less transparent if provinces rely heavily on revenues raised by another order of government. Moreover, the federal government is less able to account for the way in which its revenues are spent if they are transferred to the provinces.

Fiscal competition. Competition among provinces can have both positive and negative effects. Some argue that a positive effect is the constraining effect that inter-provincial competition has in terms of reducing the Leviathan incentive to over-extend government spending and legislate excessive taxes. This, it is argued, outweighs the adverse effects that such competition might have, including the use of taxes and infrastructure spending to attract mobile factors from other jurisdictions, and competing down standards of social programs (the so-called 'race-to-the-bottom'). One's view of the balance between the beneficial and detrimental effects of fiscal competition revolve around one's view of the benevolence of government and the weight one puts on equity versus efficiency goals.

Federal unilateralism. Making the provinces less reliant on federal transfers will reduce the chances of unexpected and unannounced cutbacks in federal transfers such as those that have occurred in the past, especially in the mid-1990s. The provinces argue that this leads to budgetary uncertainty and makes it difficult for them to plan their spending programs rationally.

Dealing with Quebec. Reducing the VFG may be regarded as a necessary means of satisfying the aspirations of Quebec, aspirations that were well summarized by the Seguin Commission. It may well be that there is much less consensus in Quebec than elsewhere in Canada for a degree of national solidarity for minimal national standards of redistributive equity. Because of the presumed difficulty of an asymmetric set of fiscal arrangement applying in Quebec, the VFG that is minimally suitable for Quebec is taken as determining what can apply in the country as a whole.

Arguments for Maintaining a Sizeable VFG

As formidable as the above arguments might be, equally formidable are those for preserving a substantial VFG. The following summarizes the latter arguments.

Tax harmonization. Whereas arguments for reducing the VFG tended to discount the importance of revenue-raising assignment, these play an important role in arguments for a VFG. In particular, the case for decentralizing expenditure responsibilities is viewed as much stronger than that for decentralizing revenue-raising, and the VFG allows one to reconcile those differences. A major argument for preserving federal dominance in revenue-raising is that it leads to a more

harmonized tax system, especially for broad-based taxes. This has advantages for the efficiency of the national economy, for maintaining some national standards of redistributive equity, and for facilitating tax administration. Put simply, the larger the share of revenues of major tax bases occupied by the provinces, the more difficult it is to maintain the kind of harmonized tax system that we have enjoyed. There is plenty of evidence in Canada to suggest that tax harmonization is likely to suffer as revenues are decentralized. Some of the most severe problems identified by the Mintz Technical Committee on Business Taxation were due to provincial and municipal taxes.

Tax competition. Related to this, it might be argued that the more decentralized the tax system, the more likely it is that the tax system will be used for adverse purposes, such as beggar-thy-neighbour policies, or simply as an instrument for self-destructive tax competition leading to a race-to-the-bottom in program spending. Of course, as the literature has shown, one might counter that provinces will find ways to engage in fiscal competition if the use of taxes are limited, and some of these other ways can be more harmful than tax competition.

National redistributive objectives. A VFG is indispensable to the extent that one views redistribution as at least partly national in nature, given that the federal government is the only government capable of addressing national goals. Of course, the extent to which redistribution is regarded as national versus provincial is a matter of judgment. It depends on the extent of consensus for redistribution and the extent to which solidarity is national versus regional. There are two ways in which a VFG contributes to the achievement of national redistributive objectives. The first is that it allows the inter-personal tax-transfer system to be designed with some common degree of progressivity nation-wide, albeit one that co-exists with provincial tax-transfer schemes. The second is that a VFG allows for the use of the spending power as an instrument for inducing national standards in provincial programs in accord with the principles set out in Section 36 of the *Constitution Act*. Given the division of legislative responsibilities, the use of the spending power is arguably the only effective policy instrument available for the federal government to fulfil these commitments.

National efficiency objectives. Similar arguments apply with respect to the role of the federal government in addressing issues of efficiency in the internal economic union. In addition to the benefits of tax harmonization already mentioned, the spending power that the VFG enables can be used to encourage provinces to design their programs in ways that facilitate national efficiency. For example, the inclusion of mobility and portability provisions in health and welfare programs have that effect.

Sustainability of equalization. The principle of equalization set out in Section 36(2) of the *Constitution Act* is so far widely accepted by provinces and the federal government alike. Maintenance of an effective equalization program was a key part of the Seguin Commission's recommendations. More generally, an agreement signed in September 2003 by the Finance Ministers of all provinces and territories stated in its first sentence: '*The Equalization Program is an*

essential component of fiscal arrangements in Canada and needs to be strengthened to fulfill its Constitutional mandate.' The decentralization of revenue-raising responsibility to the provinces makes it more difficult for the federal government to fulfill this mandate. It both increases the degree of disparities among the provinces and reduces the revenues available for the federal government to finance equalization. Perhaps as important, it might make it more difficult to maintain the political and societal consensus required to sustain an effective equalization program. This difficulty is already evident in the fact that the current system systematically avoids equalizing the most important source of fiscal disparity, that arising from oil and gas revenues. As the above-mentioned Finance Ministers' agreement documented, fiscal disparities between Alberta and Ontario are much greater than between Ontario and the equalization-receiving provinces. It should be noted that the CHST system of social transfers is itself highly equalizing: it raises revenues nationwide to finance a system of roughly equal per capita transfers. Rebalancing the federation will in itself reduce this form of equalization, which is arguably as effective as the equalization system itself.

Insurance against regional shocks. A final argument for the VFG is one that is sometimes emphasized in the international fiscal federalism literature. A system of transfers financed by a national tax system implicitly insures residents of different provinces against regional economic shocks. In Canada, there has been some emphasis put on the stabilization role of equalization, but it obviously applies more generally to the entire national fiscal system.

Prescriptions

The need to rebalance the federation cannot be avoided. Given the projected rate of growth of provincial spending relative to that of the federal government, the division of tax room between the two levels of government, and the current structure, the existing balance is not sustainable into the future. It is true that the size of the imbalance is inherently an imprecise concept. And, it is made even more imprecise by the fact that the day of reckoning can be postponed by changes in the amount of public debt. But eventually some choice must be made—explicitly or implicitly—about how to address the impending VFI, especially the extent to which federal-provincial transfers should be maintained or increased as opposed to turning further tax room over to the provinces. There is much at stake for the functioning of the Canadian economic and social union. Turning over tax room to the provinces essentially reduces the ability of the federal government to use transfers to achieve national objectives, and possibly jeopardizes the efficiency associated with a harmonized tax system. It is also largely irreversible, at least in the medium term.

The decision necessarily involves judgment of various sorts. One's view of the appropriate rebalancing will depend upon:

- One's view about the benevolence of government: The more one thinks of government as self-serving, the more one will want to decentralize revenue-raising as a way of restraining the Leviathan tendencies of government. One will be more sympathetic to a VFG the more one thinks of government as benevolent and acting in accordance with the consensus of its citizens.
- One's view about the importance of equity relative to efficiency as objectives of government: The more weight one puts on government as an institution for achieving redistributive equity, especially from the national perspective, the more one might view the VFG, and the spending power it entails, as an essential policy instrument.
- One's view about the actual equity-efficiency trade-off: One might downplay equity not so much from an ethical point of view, but also from an empirical point of view. If one thinks that significant efficiency is sacrificed to achieve redistributive equity, one will put less emphasis on the redistributive role of government.

Because so much judgment is involved, reasonable people can and do reasonably disagree about the role of the federal government vis-à-vis the provinces in achieving social and economic objectives. I take the view that the federation should be rebalanced by increasing the size of transfers, protecting and possibly enhancing the VFG, and safeguarding the share of tax room occupied of the federal government, especially in the personal income tax. This view is driven by a number of considerations, including a conviction the redistributive equity is the most important function of government, and that in the Canadian context, this ought to have a significant national dimension. In economics jargon, the social welfare function ought to exhibit aversion to inequality, and all citizens ought to be treated comparably regardless of where they reside. That is, social citizenship ought to apply nationwide.

This view is influenced by a number of observations about the functioning of the Canadian federation and its economy.

- Governments in industrialized economies are largely institutions for redistribution. A substantial proportion of program spending is motivated by redistributive considerations. Two thirds of the federal budget consists of transfers for either redistributive or social insurance purposes. More like 80 percent of provincial spending is on public services in areas of health, education and welfare, all of which are ultimately justified on redistributive grounds. The main exceptions are defense and protection, neither of which is particularly controversial.
- There is convincing evidence that governments in democratic societies are to some extent benevolent in nature, and moreover, undertake functions that reflect strong equity objectives. It would be difficult to explain programs like EI, welfare, public health insurance, and public pensions solely on the basis of the self-interest of the median voter. This not to imply that governments are perfect, and that there is no self-serving element to their behavior. But the discipline of re-election and the extent of scrutiny of government behavior—

especially at the national level—are powerful constraining devices, arguably much more powerful than those presumed to result from decentralization.

- Redistributive goals of society must ultimately be based on the sort of consensus that exists among the citizens of the nation, what the Europeans refer to as *social solidarity*. There is evidence that considerable consensus exists in Canada for a national dimension of redistributive equity, that is, for national social citizenship. The progressive income tax system, the EI system, the public pension system, the equalization system, the system of refundable tax credits for less well-off families all incorporate national standards of redistributive equity.
- There is also evidence that there is support among citizens in all regions of the country—including Quebec—for minimal national standards in some social programs that are delivered by the provinces, such as health care.
- To the extent that one takes the Constitution seriously, the principles of Section 36 clearly imply a federal role in achieving important social objectives of a redistributive nature.

Given these views, what does it imply for the rebalancing of the federation? That is, what advice would one give to a Martin government about the rebalancing of the federation? My advice would include the following elements.

- The imbalance that exists between the federal government and the provinces should be addressed by an increase in transfers from the federal government to the provinces.
- The transfers should not be contingent upon the size of the federal surplus. This puts all the risk on the provinces, which are less able to bear it than the federal government. Nor should it be contingent on federal revenues, and for the same reason. That is, we should not adopt a revenue-sharing scheme along the lines of what is used in some countries, such as Germany.
- The transfer system should be revised in some significant ways.
 1. Equalization should be rationalized along the lines suggested by the provincial and territorial Finance Ministers. In particular, we should move to a ten-province standard, which will bring oil and gas revenues into the equalization scheme. There may be some need to treat natural resource revenues of all sorts on a preferential basis because of the adverse incentive effects associated with equalizing resource revenues. At the same time, the ability of the federal government to fund the equalization of natural resource revenues—especially the disparities due to oil and gas—could be improved by reforming the corporate tax system so that it is more effective as a rent-collecting device.
 2. Social transfers should be disaggregated into three component parts: health, welfare and post-secondary education.

3. The size of the transfers in each component should be sufficient to enable the federal government to achieve its commitments with credibility. These commitments include the broad conditions that should be written into each element. The Romanow Report indicated one way that the conditions applying to health care might be revised. Similar revisions could be studied for other social programs.
 4. Social transfers of each type should escalate in accordance with some index of provincial spending requirements without unduly influencing provincial incentives.
 5. The allocation among provinces should reflect need. The simplest measures of need are demographic, and could be relatively broad.
- The federal government should desist from introducing direct spending programs in areas of provincial jurisdiction and use transfers to provinces instead. This would include Millennium Scholarships, transfers to municipalities, infra structure grants, and so on. I would even argue that transfers to universities for chairs and infrastructure are better run through the provinces.
 - In the longer run, the federal share of the tax room should be jealously guarded and even enhanced.
 - Perhaps most important, the process of managing federal-provincial fiscal relations should be addressed. Currently almost all decisions with respect to fiscal federalism are introduced as part of the annual budget process. This has a number of disadvantages. Decisions tend to be taken with regard mainly to current budgetary concerns rather than longer-term concerns for the federation. They are taken behind the veil of budget secrecy, and from time to time result in bad surprises for the provinces. There is relatively little input from outside the Finance Department, and even within that department, federal-provincial issues seem to have relatively little priority. Despite the size of federal-provincial transfers, the federal-provincial division is part of the branch that includes social policy and might not have the weight of, say, tax policy. The result is that major decisions that affect the federation are taken more by default than being matters of conscious policy. One way to open up the process and make it more transparent would be to create the kind of arms-length inter-governmental body that exists in other federations to advise on federal-provincial fiscal relations. We have mentioned the examples of Australia and South Africa earlier, but other federations have similar institutions. Of course, these bodies cannot usurp the role of Parliament in passing spending bills, but they can make the process more transparent and accountable, and provide a vehicle for taking into account the longer-run consequences of fiscal actions for the functioning of the federation.